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STATE PASS TREASURY FOR JCIORCIARI AND ABAUKOL
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TAGS: EFIN ECON ETRD EINV SN
SUBJECT: MONETARY AUTHORITY DOWNPLAYS INFLATION RISK

¶1. Summary: The Monetary Authority of Singapore (MAS) downplayed possible domestic inflationary pressures such as the upcoming two-percent increase in sales tax, double-digit rental increases, and a tight labor market during an April 24 briefing for analysts ahead of the release of its biannual Macroeconomic Review. MAS reiterated its stance that use of the exchange rate is the best tool to combat inflation. MAS asserted that Singapore's economic prospects hinged on a pick-up in demand for electronics exports expected in the second half of the year. While officially "unconcerned" and "puzzled" by the recent volatility in interbank interest rates, MAS highlighted the role that non-resident deposits played in driving down interest rates and welcomed a "two-way bet" again on the currency, which had appreciated to the strong end of its intervention band. Private sector analysts expressed concerns during the briefing that MAS was slowly losing its policy flexibility and ignoring what they perceived to be structural shifts in inflation expectations, balance of payments trends, and sources of economic growth. End Summary.

Cautious Tone

¶2. In its Macroeconomic Policy Review released April 24, MAS left unchanged its current GDP growth forecast for 2007 of 4.5 percent to 6.5 percent Q compared to a 7.9 percent actual growth rate in 2006. At a meeting with economic analysts just before the Review's release, MAS's tone was not optimistic: they stated that the risks were to the downside, driven by concerns about the electronics export cycle and U.S. demand/property price correction, with the former causing the most consternation. MAS conceded that Singapore's electronics exports had been lagging the region and noted that only South Korea had a worse electronics export performance in 2006. MAS's sectoral analyst attributed this underperformance in part to a reorganization of the domestic disk drive industry after Seagate Technology took over rival Maxtor Corp; and in part to restructuring by Hewlett Packard's Singapore operations to emphasize services over production. MAS expressed optimism that the sector's exports would turn around in H2 ¶2007.

Inflation Pressures and Interest Rate Drops

¶3. MAS dismissed concerns about domestic sources of inflation. First, echoing sentiments expressed in its March inflation forecast announcement, MAS argued that the two-percent increase in the Goods and Services Tax (GST) to

7 percent starting in July would result in a 60 to 80 percent pass-through rate, or only a 0.2 percent increase in the rate of inflation in each of the four to five quarters after the hike. Second, despite the tight labor market and the high labor diffusion index (indicating that the tight labor market was not limited to one or two sectors), MAS said it was not concerned about wage increases. (Note: Press reports have highlighted MAS's analysis about the role of foreign workers in keeping wage pressure under control and in providing a buffer for employment in downturns. End Note.) Finally, MAS said it was not worried about the effect on inflation of recent double-digit increases in commercial rentals since such expenses comprised only 10 to 14 percent of average unit costs for production for businesses. MAS asserted that external and not domestic factors remained the more likely drivers of inflation.

Consumer Price Index (2004=100)
Percentage change (year-on-year)

	CPI	% Change
1997	96.2	2.0
1998	95.9	-0.3
1999	96.0	0.0
2000	97.2	1.3
2001	98.2	1.0
2002	97.8	-0.4
2003	98.3	0.5
2004	100.0	1.7
2005	100.4	0.5
2006	101.4	1.0

2007 March	101.7	0.7

Source: Department of Statistics (www.singstat.gov.sg)

¶4. Economic analysts who attended the MAS briefing were most concerned with recent volatility in interest rates. MAS reiterated that its monetary policy only targeted the exchange rate, keeping a neutral liquidity stance that enabled the interest rate to be determined by the market. While MAS maintained that interest rates were a "market phenomenon" and that they were "just as puzzled" as the analysts about what was driving the rates, it offered two possible explanations for the drop: 1) a large inflow of non-resident funds, particularly non-resident "quasi fixed deposits" and "transactional accounts"; and 2) lower interest rates in those countries whose currencies comprise the basket of denominations MAS uses to peg the Singapore dollar, assuming that the theory of interest parity held. (Note: The one-month Singapore Inter Bank Offer Rate (SIBOR) -- the interbank interest rate that is usually the reference rate for pricing loans in Singapore dollars -- has fallen 100 basis points, i.e., one percentage point, since the beginning of the year to 2.44 percent. See chart below. End note.)

Domestic Interest Rates

End of Period	Interbank 1-Month
2007	
Jan 05	3.44
Jan 12	3.41
Jan 19	3.38
Jan 26	3.38
Feb 02	3.38
Feb 09	3.38
Feb 16	3.38
Feb 23	3.38
Mar 02	3.31

Mar 09	3.13
Mar 16	3.00
Mar 23	3.00
Mar 30	2.94
Apr 05	2.88
Apr 13	2.75
Apr 20	2.44

Source: MAS (www.mas.gov.sg)

¶5. Despite MAS'S professed neutrality, one official conceded that it was not inherently undesirable to have "more symmetrical risk" in the currency market as was the case currently. One analyst explained that lower interest rates meant that expected returns for holding Singapore dollars were roughly on par with expected returns for holding U.S. Treasuries, and thus this shift to a more balanced outlook would reduce speculative pressures on the Singapore dollar.

FX Reserves Build-Up

¶6. One analyst questioned the rate of increase in Singapore's FX reserves, noting that MAS had heretofore maintained that its current account surplus, which ran to US$37 billion or 28 percent of gross national income in 2006, was not a concern as it was "recycled" outward through the capital account by parties re-investing the funds overseas. He pointed out that this recycling had ceased recently, resulting in a rapid accumulation of FX reserves, especially reserves plus net forward positions. According to the analyst, the current account surplus plus net forward position is 25-30 percent of GDP and foreign exchange reserves are 130 percent of GDP. He asked if this was an issue for monetary policy, and whether MAS considered this to be a "permanent shock" or a cyclical issue. MAS responded only that money had to be flowing back out, perhaps through the net foreign assets of the banking sector or through corporate investment overseas. (Note: MAS data show that the official foreign reserves increased by US$10.5 billion to US$136.6 billion in 2006, an acceleration from the US$5.9 billion increase in 2005. End note.)

Comment

¶7. To its credit, MAS has a respectable track record of keeping inflation below 2.0 percent on an annualized basis. However, there may be some merit to analysts' concerns about domestic sources of inflation and unease about MAS's monetary policy choices. MAS's belief that external shocks pose the biggest inflation risk to the economy drives its use of the exchange rate rather than the interest rate as its monetary policy tool to manage inflation. However, too much allegiance to this monetary policy regime may be leading to an excessive focus on old drivers of the economy (such as electronics exports) at the risk of ignoring new threats that would challenge MAS's monetary policy paradigm. In particular, the risks of domestic sources of inflation (GST, property prices, wages, falling interest rates) might be hard to mitigate using only the exchange rate as a tool, especially when the Singapore dollar is near the strong end of its band, as it has been until recently. The contrast between MAS's gloomy outlook and the higher than expected 7.2 percent first quarter GDP growth figure also announced on April 24 only highlighted the disconnect that worries analysts. End Comment.

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